The Economy in a Changing World

March 1985

Province of British Columbia

The Honourable Hugh Curtis, M.L.A.
Minister of Finance

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THE ECONOMY IN A CHANGING WORLD

Introduction

The purpose of this paper is to provide British Columbians with a broad overview of the provincial economy and the considerations that have provided the foundation for economic policy in the province over the past three years. This analysis continues to guide government policy and underlies the program of partnership for economic renewal outlined in the 1985 Budget Speech.

The paper has three main sections. The first presents an overview of the current structure of the British Columbia economy and a description of the way in which external influences affect the province. The second section examines the significance of recent economic developments in the context of longer-term forces affecting the provincial economy. The final section discusses the economic policy tools available to provincial governments and, broadly, how they have been employed by the Government of British Columbia.

1. British Columbia's Economic and Industrial Structure

British Columbia's economy is dominated by resource extraction and processing and is heavily reliant on foreign trade. The rich endowment of natural resources and their development as the backbone of the province's economy has meant that economic activity in all sectors is affected by developments in markets for lumber, mineral and energy resources. The province's small population alone cannot support local production of mass-produced consumer goods nor provide a market for the potential production of natural resource products. As a result, extensive trading relationships have been developed with the rest of the world for both sales of resource products and importation of items not available locally.

By taking advantage of the natural resource base, British Columbians have attained a higher standard of living than otherwise would have been possible. Large volumes of exports have permitted the importation and consumption of many end-products and foodstuffs which would have been either totally unavailable or far more costly if they had been produced in British Columbia to meet local needs alone. In addition, access to larger world markets has allowed British Columbia firms to produce at lower costs by taking advantage of economies of scale.

The significance of international trade to British Columbia is illustrated by the fact that the major portion of the output of the province's two most important industries, forestry and mining, is shipped abroad. In 1983, over 70 per cent of the production of the British Columbia wood, paper and allied products manufacturing industries was exported outside Canada. Similarly, approximately 55 per cent of non-energy mineral shipments went to foreign countries. Such data as is available suggests that a smaller, but significant percentage of these industries' output was also shipped from British Columbia to other Canadian provinces.

The importance of trade is even greater when looked at from the standpoint of the residents of British Columbia's many one-industry towns. In communities such as Port Alberni, Stewart and Trail, the internationally-determined price of a single commodity, such as lumber or gold or copper, can signal boom or depression, regardless of what is happening in other parts of the province.

REGIONAL DIMENSIONS OF THE BRITISH COLUMBIA ECONOMY

Discussions concerning provincial economies often assume that they are homogeneous entities, with few distinctions between regions. However, just as provinces have separate, distinct "economies", in some instances sub-provincial regions may have their own unique characteristics. In fact, some regions of a province may have stronger links with other provinces or countries than with the remainder of their own province.

British Columbia's regions have very diverse economic characteristics. There are great geographical, geological and climatic differences within the province that lead to very different regional consumption patterns and industrial structures. Consumption patterns of Lower Mainland and southern Vancouver Island residents differ markedly from those of the people who live in the northeast part of British Columbia. Also, the economies of these two regions differ significantly with the Lower Mainland and southern Vancouver Island being heavily dependent on service industries, tourism and secondary manufacturing and the northeast relying on grain, coal and natural gas production.

The focal points of many regions of the province are one-industry towns whose prosperity depends on a particular commodity. A decline in the price of such a key product can create great difficulties for an entire region. By contrast, the Lower Mainland is also affected by slumps in the province's key industries, but the region's relatively diverse economic base insulates it from shocks that can seriously affect smaller regional centres.

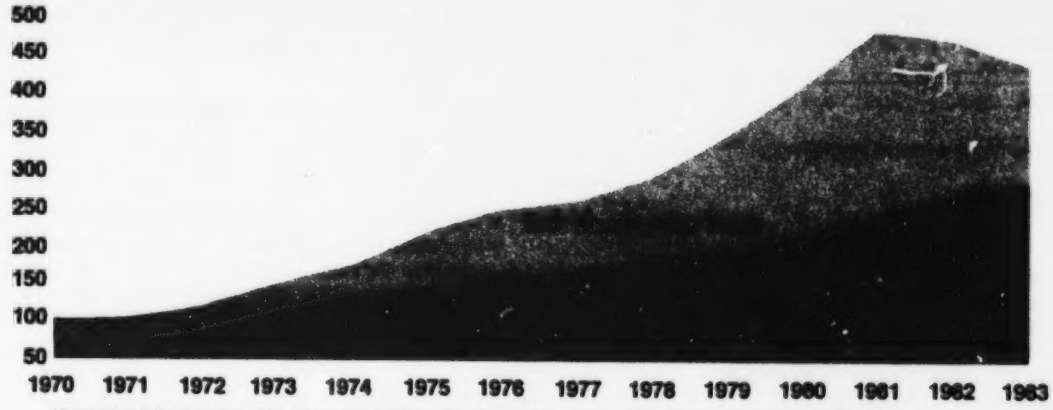
International trade is clearly of fundamental importance to the major goods-producing industries, but it is also taking on increasing significance for the province's large and varied service sector. Accounting for over 70 per cent of provincial employment, the service industries have many direct and indirect links to the export sector. For example, although tourism is often thought of as a domestic industry, it earns substantial income from out-of-province customers and is therefore more accurately considered an export industry. A less obvious connection between service industries and foreign markets is the income generated from sales to the trade-oriented, goods-producing industries. As Canada's gateway to the Pacific, for instance, British Columbia has a strong base of employment in transportation and related activities, which in turn are tied closely to the merchandise trading activities of this and other provinces. Opportunities are also growing for the export of high value-added services based on the knowledge and expertise developed in the resource industries.

In addition to being strongly influenced by external trading relationships, the economic structure of British Columbia is affected by the way in which markets for labour, capital and natural resources in the province are connected. Due to British Columbia's small population and limited pool of savings, large capital inflows have been required to finance major investments in hydroelectric generating capacity, rail lines, mines, smelters, port facilities, lumber and pulp mills. These inflows have permitted British Columbians to develop the resource base without an excessive sacrifice of current consumption in favour of savings for investment. Similarly, migration from other provinces and countries has provided the work force needed by the expanding economy.

However, attracting the financial and human resources necessary for the province's economic development is not a matter of neat and simple adjustments to meet the immediate needs of the economy. Capital and labour have come to British Columbia because earnings are generally higher here than elsewhere and because there has been tremendous growth in demand for our resource products.

As a result, when export sales volumes and prices rise, employment and incomes in British Columbia grow, consumption of both domestic and foreign goods and services increases, and capital investment in buildings, housing and equipment accelerates. Conversely, when export markets weaken, employment, incomes, consumption and investment are negatively affected. Through this mechanism, fluctuations in international markets and trade activity ripple through the entire provincial economy. These linkages explain why areas of the British Columbia economy with little direct involvement in international markets have been affected by the cyclical nature of the export-oriented sectors.

CHART 1



[1]Current-weighted export price index for lumber, pulp, newsprint, copper, zinc, aluminum, coal and natural gas.

Source: Based on data from Statistics Canada and the Central Statistics Bureau

THE STRUCTURE OF THE BRITISH COLUMBIA ECONOMY

Output

Goods Industries	Percent of Provincial GDP** 1977–82
Forestry*	11.4
Mining*	7.5
Other Primary*	3.9
Other Manufacturing	4.4
Construction	7.5
TOTAL	34.7

* includes related manufacturing

** GDP, or Gross Domestic Product is the total value of goods and services produced in British Columbia. Latest detailed data available is for 1982.

- Production of goods accounted for approximately 35 per cent of total economic output from 1977–82. Resource industries and related manufacturing contributed over 60 per cent of the total output of the goods-producing sector. Most of the sector's output was exported.
- The goods-producing sector's share of total output has declined from 38 per cent in 1962.

Service Industries	Percent of Provincial GDP 1977–82
Utilities	3.8
Transportation, Communications and Storage	9.9
Wholesale and Retail Trade	11.8
Finance, Insurance and Real Estate	11.7
Community, Business and Personal Services	21.3
Public Administration	6.8
TOTAL	65.3

- Output of services accounted for approximately 65 per cent of total economic output from 1977–82, up from 62 per cent in 1962.
- Community, business and personal services were responsible for 33 per cent of service sector output. Approximately 45 per cent of the output of this component was accounted for by the public sector.
- The tourism industry was responsible for a large share of the output of three of the service sectors, and accounted for approximately 5 per cent of gross domestic product. Tourism is affected by foreign economic conditions and competitive factors in much the same way as other trade-oriented sectors.

—Continued

Employment

Goods Industries	Percent of Provincial Employment 1977–84
Agriculture	2.3
Forestry, Mining, Other Primary	4.4
Manufacturing*	14.4
Construction	6.6
TOTAL	27.7

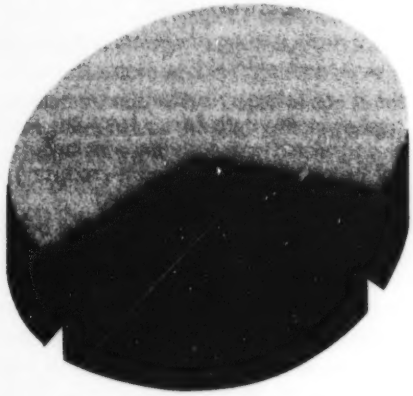
* includes resource-related processing.

- From 1977–84 the largest employers in the goods-producing sector were the manufacturing and resource-related processing industries, with 14.4 per cent of total employment. Construction and primary industries were each responsible, respectively, for 6.6 per cent and 4.4 per cent of total employment.

Service Industries	Percent of Provincial Employment 1977–84
Transportation, Communication and Utilities	10.0
Wholesale and Retail Trade	18.4
Finance, Insurance and Real Estate	6.0
Community, Business and Personal Services	31.1
Public Administration	6.8
TOTAL	72.3

- The service sector provided 72.3 per cent of provincial employment from 1977–84. Community, business and personal services accounted for 31.1 per cent, and wholesale and retail trade for 18.4 per cent.

Export Share (1977-82)



Exports

- Merchandise exports accounted for 30.7 per cent of GDP from 1977–82. In the 1963–82 period, the export share ranged between 25 and 36 per cent of GDP.

Imports

- Gross merchandise imports and net service imports accounted for 31.9 per cent of GDP from 1977–82; the 1963–82 share ranged between 25 and 36 per cent.

Source: Central Statistics Bureau

2. A Historical Perspective on British Columbia's Economic Development

Extraction, processing and export of natural resources has been the driving force of British Columbia's economy since the arrival of the first European fur traders.

The fur trade, the province's first major industry, eventually gave way to mining following the gold rush in the Cariboo in the late 1850s. By the 1870s, the first resource-based manufacturing industry had been established, as salmon canneries were constructed to produce primarily for export markets. In the 1870s and 1880s, forestry began to assume importance as the building of the transcontinental railway greatly increased demand for British Columbia lumber on the prairies. Following World War I, the opening of the Panama Canal provided shipping

access to Europe and the eastern United States for British Columbia's largely untapped wealth of natural resources. As a result, seventy times more lumber was produced in British Columbia between 1921 and 1930 than during the 1871-80 period. Similarly, pulp and paper production expanded in the 1920s to join lumber and mining as a key provincial industry.

During the interwar period, Canada's and British Columbia's trading relationships with Britain were diminishing in significance while trade with the United States was increasing in line with that country's rapid industrialization and growing need for raw materials. Military production during the Second World War required extensive quantities of mineral resources which further spurred the development of British Columbia's mining industry.

The Postwar Period

This trend continued through the postwar period as the value of exports from British Columbia expanded by a factor of ten between the end of the Second World War and 1970.

A major contributing factor was the expansion in trading activity arising from the general liberalization of world trade in the postwar period. The Kennedy and Tokyo rounds of trade negotiations led to reductions in both tariffs and other barriers to trade. As a result, British Columbia was able to develop trade relationships with a growing number of countries. This market diversification reduced the province's vulnerability to economic conditions in any particular jurisdiction and at the same time produced rapid growth in the overall volume of the province's foreign trade.

Rising demand for labour in British Columbia in this period was met by continuing migration from other parts of Canada and abroad. Financial institutions and investors throughout Canada and around the world recognized that the young, resource-rich province was an attractive place for investment and the capital necessary for economic development was readily provided. In support of the resource industries, their related manufacturing activities and their employees, the service sector of the British Columbia economy expanded rapidly. Transportation systems, financial services, consulting and engineering firms and local service businesses grew to meet the increased demands emanating from developments in the resource sector.

Despite rapid growth of the service sector and diversification in the postwar period, British Columbia's economy continues to be both resource-based and export-oriented, and as a result it is still very sensitive to market fluctuations in Canada and abroad. For example, housing activity in the United States remains one of the most important determinants of economic activity in British Columbia because of its impact on the demand for lumber.

The 1970s Boom

For many areas of the world, the 1970s and the first half of the 1980s represented a period of extraordinary volatility. Demand for resource products grew rapidly through most of the 1970s, with a brief interruption at mid-decade, and the declining value of the United States dollar against the Japanese and major European currencies made North American products more competitive in world markets. After 1976, the Canadian dollar began to decline against its U.S. counterpart, giving added advantage to British Columbia's products.

Rapid and sustained growth in energy and other commodity prices, combined with double-digit inflation were new experiences for most individuals, businesses and governments. British Columbia benefitted significantly from favourable demand conditions for resource products. Prices for the province's exports escalated rapidly, reaching record highs in the late 1970s. Similarly, the incomes of British Columbians grew rapidly, enabling them to consume increasing amounts of goods and services.

The 1970s take on significance not only because of the immediate impacts of the resource boom, but also because the stage was being set for severe economic problems to occur in the early 1980s. Unfortunately, the buoyant economic conditions of the period disguised the fundamental changes that were taking place, and few were prepared for what was to follow.

The postwar economies of the industrialized countries depended on reliable supplies and stable prices for energy and raw materials. Production processes and capital equipment were designed to reflect the historically accepted range of energy prices.

However, when energy prices rose sharply following the first Middle East oil embargo in 1973, predictions of shortages and ever-increasing prices generally became the norm. There emerged widespread skepticism about the ability of large, capital-intensive industrial enterprises to become more energy-efficient and supplies of energy and natural resource commodities were feared to be unresponsive to price changes. These predictions were translated into gloomy outlooks which suggested that high economic growth among industrialized countries was tied intrinsically to high rates of energy and natural resource consumption. A conventional wisdom emerged that high energy prices would severely impair the economies of industrial and developing countries alike.

In anticipation of the adverse impact of the massive transfer of wealth to the oil-producing countries, several industrial nations attempted to accommodate the increases in the price of energy through expansive monetary policy or controls on energy prices. Monetary expansion placed upward pressure on the general price level, and inflation began to build in countries pursuing such policies. Countries such as Japan and West Germany which immediately absorbed the oil price shocks and did not resort to monetary expansion or price controls to cushion the impact, ultimately weathered the energy crisis much better than Canada and other countries which tried to avoid the difficult adjustments.

Oil price increases were not the sole reason for inflationary monetary policies. In the late 1960s, government spending had expanded rapidly in many countries, particularly the United States. This trend continued through the 1970s in the industrial countries as governments expanded social programs and the range and quality of other public services. Increased spending was often justified, at least partly, as economic stimulation, and governments chose not to impose the additional taxes required to finance it. The result was a massive build-up of public sector debt, financed by the inherently inflationary practice of rapid monetary expansion. Table 1 shows the impact of the growth of debt on governments' debt interest costs.

Table 1

Government Debt Interest Payments as a Percentage of Gross National Product

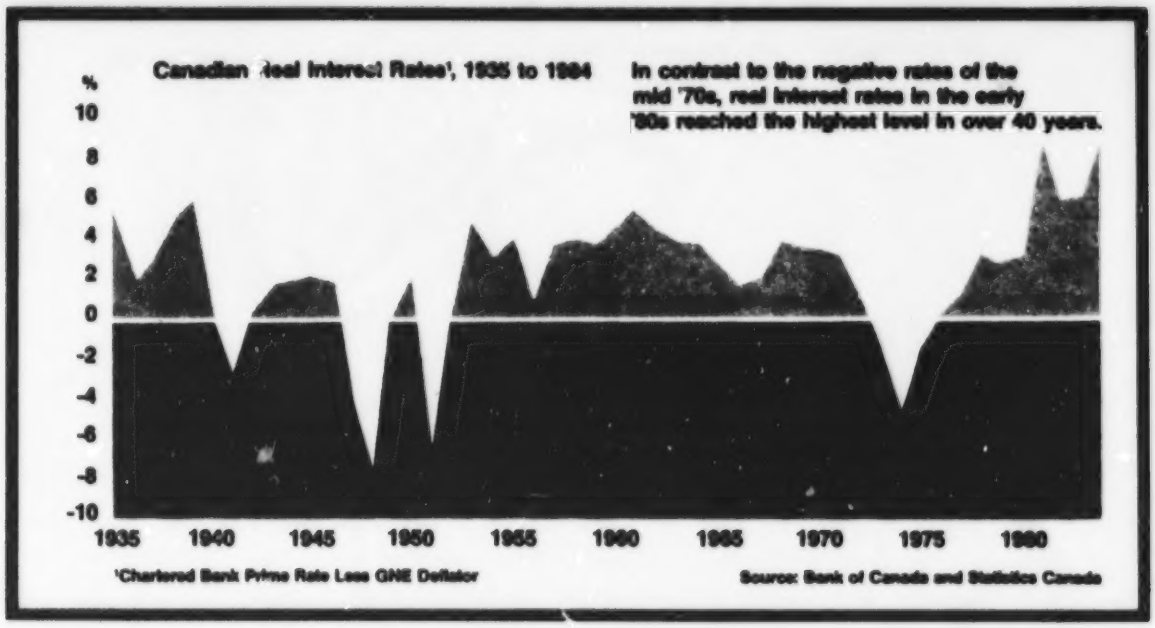
	1970	1975	1980	1985
Canada	3.8	4.0	5.6	7.9
United States	2.2	2.5	3.3	5.5
Japan	0.6	1.2	3.2	4.7
West Germany	1.0	1.4	1.9	3.0
France	1.1	1.3	1.6	3.2
United Kingdom	3.9	4.0	5.6	4.3
Italy	1.7	4.0	6.3	10.1
Average	1.9	2.3	3.4	5.2

Source: Organization for Economic Co-operation and Development, *Economic Outlook* (December 1984). 1985 data are projected.

In many less-developed countries, similar inflationary policies designed to cope with higher energy prices and provide funds for massive investment projects were pursued on a much larger scale. With expanding debt loads and accelerating currency depreciations, hyperinflation was a frequent result.

The seeds of the international debt crisis of the 1980s were sown in this period. Expansionary monetary policies combined with enormous pools of so-called petrodollars meant that loanable funds were readily available. In fact, through much of the 1970s, real interest rates (nominal interest rates minus the expected rate of inflation) were negative, implying that profits could be anticipated from borrowing money and investing in physical assets which were appreciating in value. Consequently, a great deal of debt was incurred to finance projects which would have been regarded as uneconomic had normal, positive real interest rates prevailed.

CHART 2



British Columbia, as a major natural resource and energy producer, was well positioned to benefit from the price increases and resulting investment surge, but proved vulnerable to the subsequent adverse price and interest rate developments.

Table 2 shows the effect of rapid price increases on the value of mineral and energy production. Along with export earnings resulting from such increases, personal incomes, corporate profits and government revenues grew rapidly. For example, between 1978 and 1981, wages and salaries rose 52 per cent, pre-tax corporate profits grew 36 per cent and retail sales increased 46 per cent. Similarly, British Columbia government revenues increased 40 per cent while expenditures rose 52 per cent.

Table 2
Natural Resource Production and Value, 1978–1981

	Volume (% change)	Value (% change)
Copper	6.0	41.6
Lead	4.7	19.1
Zinc	– 17.2	28.8
Silver	77.7	238.1
Natural Gas	0.7	54.6

Source: Ministry of Energy, Mines and Petroleum Resources.

Reflecting nearly a decade of buoyant economic conditions, plans were made on the expectation that these growth patterns would continue. Corporate commitments to expansion requiring long lead times were made and consumers adjusted their expenditure patterns, making purchases of real estate and other products that previously had been unaffordable. The quality and range of public services were also expanded, partly in response to the population growth caused by rapid in-migration and partly in anticipation of continued strength in government revenues.

It is against this background of low real interest rates, high inflation, and booming economic conditions that the severity of the 1981-82 recession should be viewed. Economic and financial decisions and commitments tended generally to reflect assumptions of a continuation of this pattern, an expectation which was not met.

CHART 3

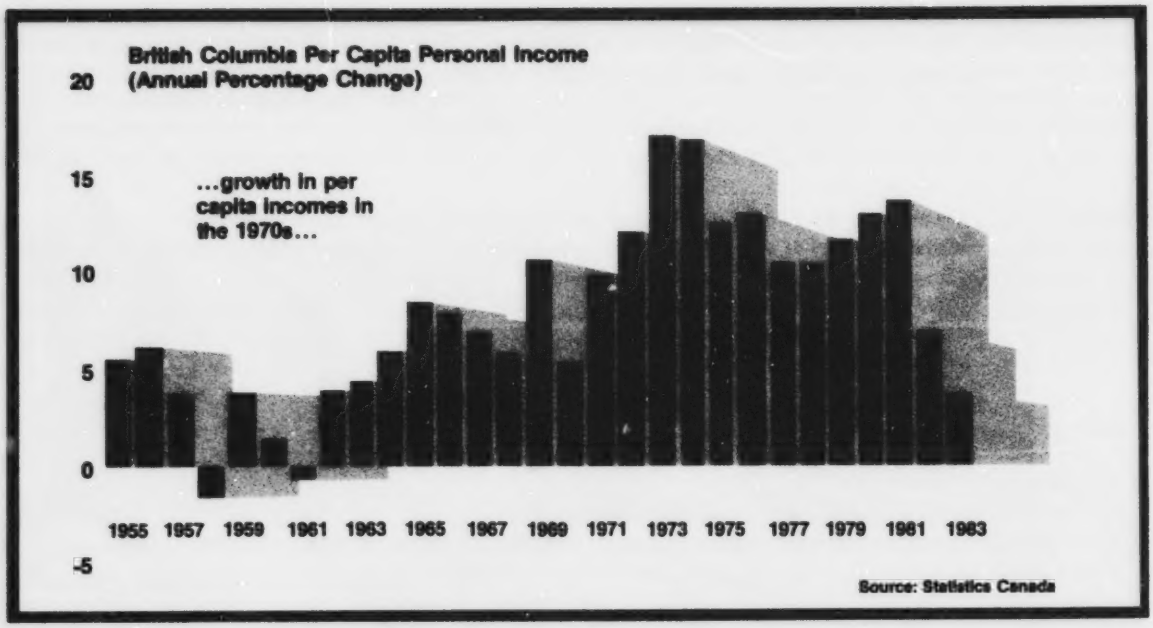


CHART 4

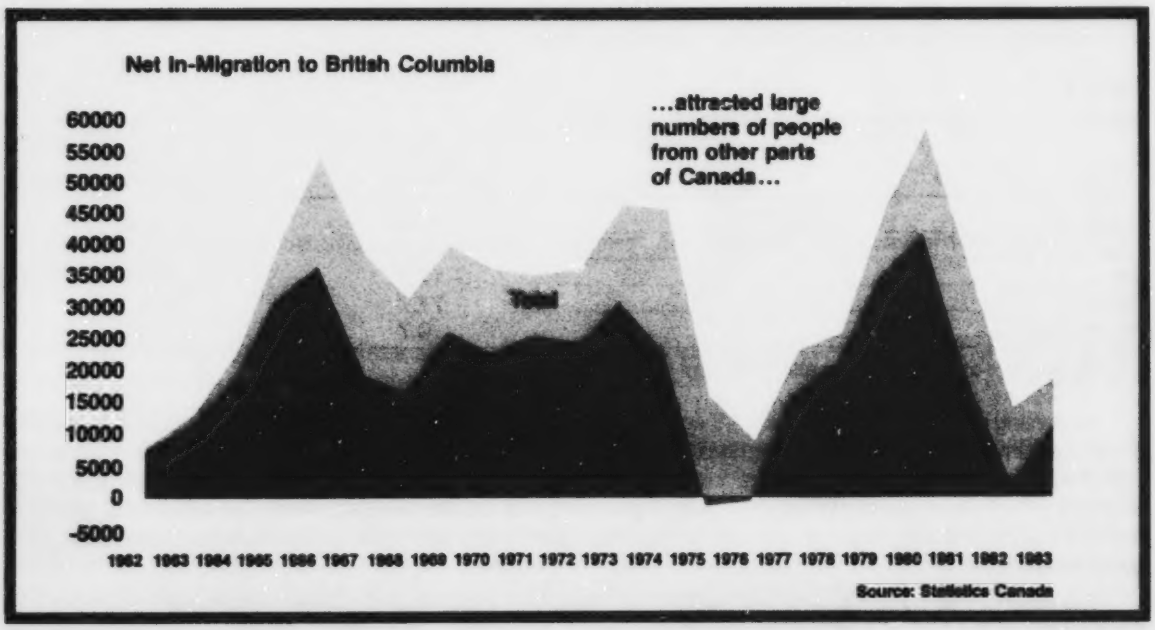
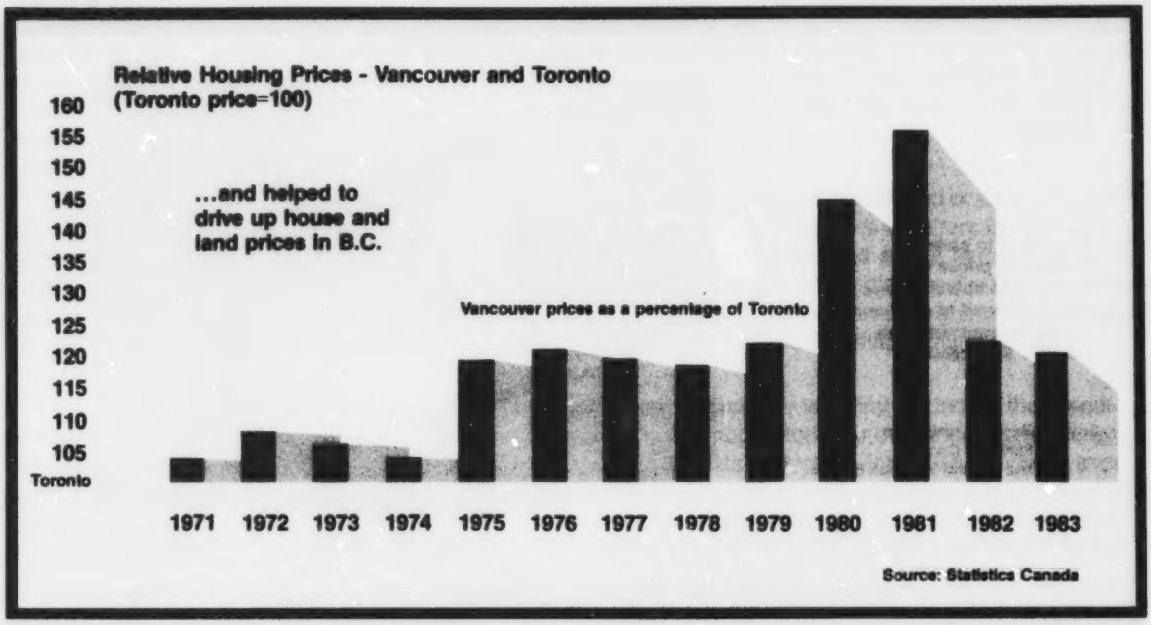


CHART 5



The 1981–82 Recession

Due in large part to a simultaneous monetary contraction in a number of the world's major industrial economies (see "International Financial Developments" box), British Columbia and Canada in late 1981 went into the worst recession since the Great Depression. Provincially, the recession's impact has persisted due to the failure of key commodity export prices to return to levels sufficient to cover the high cost base built up over the previous decade, much less provide for a reasonable return on investment. Heavy debt loads meant high fixed costs for interest payments, and high wage costs reflected the more buoyant labour markets of the previous decade. Moreover, a substantial amount of production capacity dedicated to processing high-cost resource supplies (such as low-quality mineral ores and smaller trees) had been brought on stream under expectations of continuing boom conditions. These factors virtually precluded profitable operation when resource prices fell.

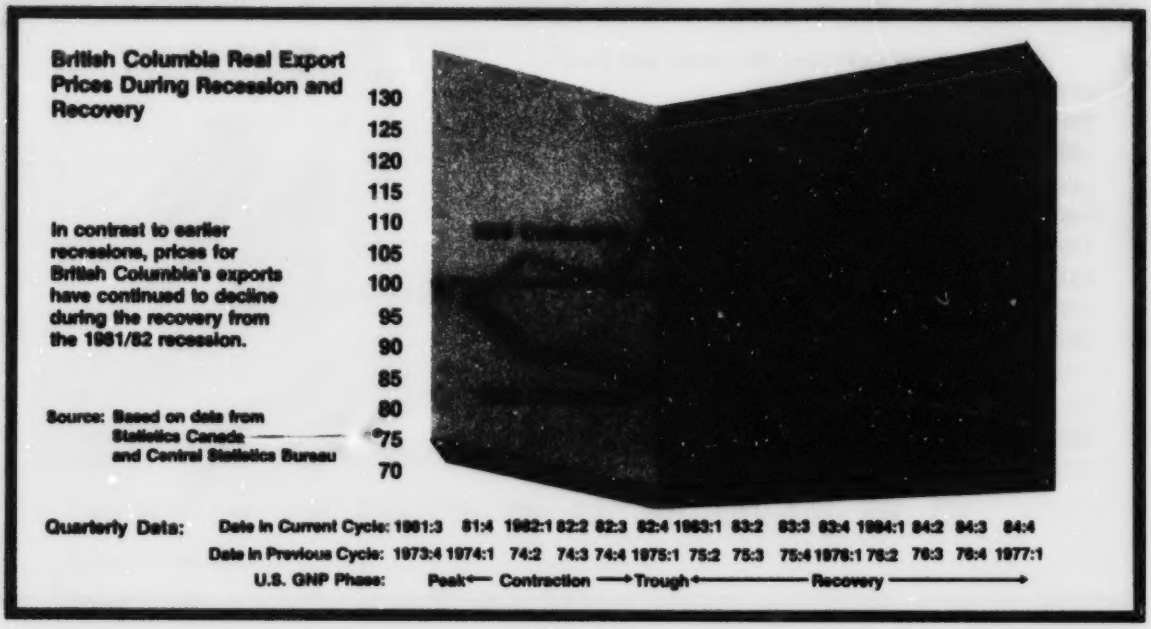
Chart 6 below shows that the prices of British Columbia's key exports have remained depressed during the recovery from the 1981-82 recession in contrast to their behaviour following the 1974-75 downturn. Why have commodity prices not rebounded as in previous periods when the United States and other industrialized countries have emerged from a recession?

Perhaps the most important factor has been real interest rates which, in most countries, have remained very high, particularly in comparison with the lower or negative real interest rates that prevailed in the 1970s. The result has been depressed investment spending in many countries, and a reduced demand for raw materials.

Even without these factors, however, it is unlikely that the extremely high commodity prices of the late 1970s would have been sustainable. Consumers reached the point where they began to reduce their use of these products and to seek less costly substitutes. At the same time, producers were motivated by strong prices to tap vast new supplies in established production regions as well as from remote areas of the world where resource bases were quickly developed.

Increased supplies and reduced demand caused commodity prices to level off and, in many cases, decline. The clearest example of such developments is found in the world oil market. Once dominant OPEC producers have lost much of their control over oil prices because the high prices established in the 1970s brought forth new supplies from areas such as the North Sea, Mexico and Alaska, and at the same time encouraged conservation among consumers.

CHART 6


British Columbia Real Export Prices During Recession and Recovery
In contrast to earlier recessions, prices for British Columbia's exports have continued to decline during the recovery from the 1981/82 recession.
Source: Based on data from Statistics Canada and Central Statistics Bureau
130
125
120
115
110
105
100
95
90
85
80
75
70
Quarterly Data:
Date in Current Cycle: 1981:3 81:4 1982:1 82:2 82:3 82:4 1983:1 83:2 83:3 83:4 1984:1 84:2 84:3 84:4
Date in Previous Cycle: 1973:4 1974:1 74:2 74:3 74:4 1975:1 75:2 75:3 75:4 1976:1 76:2 76:3 76:4 1977:1
U.S. GNP Phase: Peak Contraction Trough Recovery

International Financial Developments

An important factor leading to the end of rising commodity prices and double-digit inflation was the decision in late 1979 by U.S. monetary authorities to mount a determined assault on inflation. Initially, there was widespread skepticism about the resolve of the U.S. Federal Reserve Board, even when a number of central banks in other countries took similar actions. However, when energy prices rose in 1979 following the second major Middle East oil production cutback and the monetary authorities in the U.S. and other countries did not react by rapidly expanding money supplies, it was apparent that the fight against inflation was beginning to have some impact. This became clearer when other commodity prices failed to escalate along with energy prices.

One of the effects of anti-inflation policies was to raise interest rates and the exchange rates of countries pursuing them. This made exports of such countries less competitive and forced radical cost adjustments on producers. British Columbia experienced this pressure particularly when the Canadian dollar began to appreciate against European and Japanese currencies in 1981 and 1982.

Despite evidence of success in fighting inflation, the combination of tight monetary policy and expansionary fiscal policies drove nominal and real interest rates to higher and higher levels in the industrialized countries. Ultimately, this led to the sharp decline in economic activity throughout the world in 1981-82, the subsequent collapse of commodity prices and the inability of Third World countries to service their massive debts. Further eroding the prices of certain resource products was the tendency of a number of debtor nations to continue supplying large volumes of commodities, such as copper, on the world market in order to earn the foreign exchange required to service their loans.

The Impact of Falling Commodity Prices on British Columbia

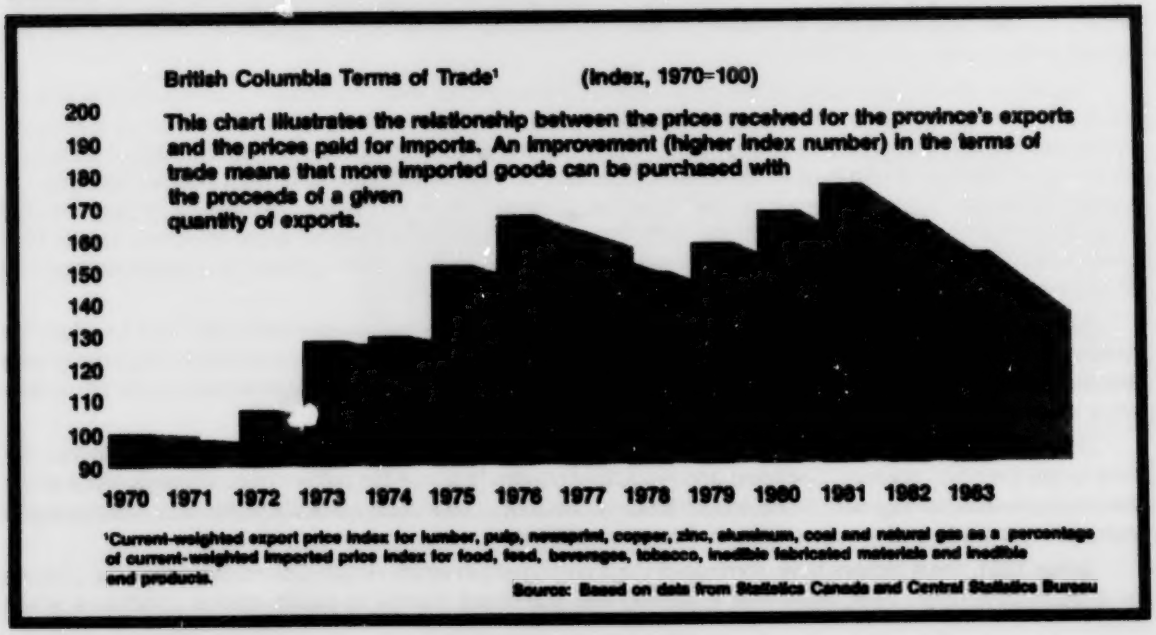
Chart 7 illustrates the effect of the sharp break in commodity prices, which actually began with the brief U.S. recession in 1980. By 1981, the value of British Columbia's exports relative to the cost of imports had begun to fall. In aggregate, British Columbians were no longer earning enough from export sales to support the level of consumption enjoyed in the late 1970s. For example, it would now take twice as much lumber to purchase an Ontario-made automobile as compared to the amount that would have been required at the peak of the commodity boom.

The effects of this were felt throughout the provincial economy. As export prices fell and costs continued to rise, losses mounted and many operations were shut down. Major cost-cutting efforts were required for most of British Columbia's natural resource producers to stay in business. Layoffs resulted as the higher-cost plants curtailed production, and many jobs were eliminated permanently in cases where plant and equipment were modernized to offset British Columbia's traditionally high labour costs. This was particularly common where it was not possible for producers to renegotiate costly labour contracts. As a result, British Columbia's unemployment rate rose sharply.

The impact of this environment on collective bargaining in the province was first evident in the resource sectors where, in the face of bankruptcies and layoffs, many unions moderated their demands and some even negotiated rollbacks. Recognizing that few of the economic restraints that came into play in private sector negotiations existed in traditional public sector collective bargaining, the provincial government established the Compensation Stabilization Program to limit public sector wage settlements and ensure a more equitable sharing of the burden of economic adjustment between private and public sector employees.

As the effects of declining resource prices worked through the economy, personal incomes, consumer spending, and investment and construction activity declined. Adding to the difficulties was the enormous burden of consumer, business and federal government debt that had accumulated when inflation and interest rates had risen to unprecedented levels. Dealing with this debt in an environment of falling asset values and incomes meant that, for a significant period of time, priority would be placed on debt reduction ahead of consumption and investment spending. The resulting weakness of domestic demand in British Columbia compounded the short-term problems associated with the weakness in external demand, but has strengthened the financial position of British Columbia businesses and individuals to the benefit of longer-term stability.

CHART 7


British Columbia Terms of Trade[1] (Index, 1970=100)
This chart illustrates the relationship between the prices received for the province's exports and the prices paid for imports. An improvement (higher index number) in the terms of trade means that more imported goods can be purchased with the proceeds of a given quantity of exports.
200
190
180
170
160
150
140
130
120
110
100
90
1970 1971 1972 1973 1974 1975 1976 1977 1978 1979 1980 1981 1982 1983
[1]Current-weighted export price index for lumber, pulp, newsprint, copper, zinc, aluminum, coal and natural gas as a percentage of current-weighted imported price index for food, feed, beverages, tobacco, inedible fabricated materials and inedible end products.
Source: Based on data from Statistics Canada and Central Statistics Bureau

Post-1982

The difficult period experienced in British Columbia since the 1981-82 recession has been a time of adjustment to a fundamental realignment of world commodity prices. This realignment, unfortunately, has occurred for products of the sectors which form the backbone of the British Columbia economy: forest products, minerals and energy products, in particular. The high value of the Canadian dollar in relation to currencies other than the United States dollar has also made the adjustment that much more difficult for British Columbia's producers. It has meant that, in some world markets, provincial exporters have become high-cost suppliers.

It is important to emphasize that the pattern of prices now prevailing in the world marketplace, while weak in relation to much of the 1970s and early 1980s, may not be an aberration from a longer-term historical perspective. The economy has declined from a very high level. There is now a heightened recognition by business, government and labour that cost adjustments must reflect the prevailing patterns of prices and competition. It is no longer possible to rely for prosperity on sustained demand growth and strong prices for basic export commodities.

The end of the commodity price boom and the drastic reduction in provincial natural resource revenues signalled the need for government to join business and individuals in adjusting to changing economic circumstances. Rapidly increasing revenues in the 1970s had allowed all governments to introduce new programs and enrich existing programs, resulting in an increase in governments' presence in the economy. At the same time, unrealistic expectations developed regarding the ability of governments to solve social and economic problems. The experiences of the early 1980s have caused the citizens of most industrial countries to reconsider the role they wish their governments to play, and they are increasingly signalling a desire for smaller and more efficient public sectors.

3. Provincial Government Economic Policy

For analytical purposes, it is useful to divide government economic policies into two general categories. Macroeconomic policies affect the overall level of economic activity and employment. Microeconomic policies are used to alter the patterns of economic activity as between sectors or regions of the country.

Macroeconomic, or stabilization policies, use changes in total government expenditure and taxation levels to attempt to offset cyclical fluctuations in the economy caused by the normal ups and downs of business activity. For example, during a recession, the government can attempt to maintain the level of demand and economic activity by spending more than is received in revenue. Although this seldom eliminates recessions, it helps to reduce their impact.

In general, stabilization policies are more effective at the national level. Provincial economies rely heavily on trade with other provinces and countries. Consequently, the potential impact of provincial fiscal policy is reduced by the leakage of demand stimulus, through increased imports of goods produced in other jurisdictions. Further, provincial industries relying heavily on external markets do not benefit materially from policies designed to stimulate demand within the province. Because the Canadian economy is less dependent on exports and imports than any single province, federal stabilization policy can be somewhat more effective. The federal government's ability to stabilize the level of demand in the economy is also strengthened by its exclusive control of interest rates and monetary policy.

In the area of microeconomic policy both the federal and provincial governments are able to affect the pattern of economic activity. At the national level, international trade policy, taxation policy, expenditure programs and regulation all represent potent instruments for encouraging certain sectors and patterns of economic activity while discouraging others.

Provincial governments are again constrained constitutionally from legislating in certain areas, but they are able to use their own taxation, spending and regulatory powers to shape the pattern of economic activity within the province. Provincial governments are particularly circumscribed in their authority to affect international and interprovincial trade and transportation and communications.

Since 1981, three factors have dominated the environment in which British Columbia's economic policies have been developed. First, there was a sudden and sustained change in export market conditions which

threatened to destabilize the provincial government's finances. Second, the cyclical downturn in the economy in 1981-82 resulting from weak export markets caused severe financial problems for the province's businesses and consumers. Finally, rapid structural changes in the world economy have shifted the emphasis of business from increasing production to meet growing demand toward improving productivity and cost control in a more competitive marketplace. This has altered the types of government policies required to achieve growth and stability in all countries.

Recognizing these radically changed circumstances and the constitutional and practical constraints on provincial actions, the Government of British Columbia undertook a restructuring of economic policy. In essence, macroeconomic policy has been used to cushion the effects of economic adjustment while a major re-orientation of fiscal priorities and microeconomic policies has been undertaken.

In February 1982, the government introduced a general program of restraint on government spending and the innovative Compensation Stabilization Program. The purpose was to reduce the expenditure base of the provincial government by eliminating less essential programs, increasing the efficiency of government administration and program delivery and limiting the rate of increase in public sector compensation levels. Prior to the restructuring of government policy, public sector compensation and service levels had risen quickly, consistent with the general boom psychology in the province in the late 1970s and early 1980s. As Charts 8 and 9 show, government contributions to major social programs in British Columbia exceeded those in other provinces. Through the restraint program, the government has attempted to bring compensation and service levels into balance with the ability of the taxpayers to finance them and closer to the levels prevailing in the rest of Canada. In addition, the reduction in government staffing levels by 25 per cent between 1982 and 1985 reflected a major drive to increase the productivity of the public service and reduce the general overhead costs of government, consistent with the direction being taken in the private sector to cope with a more difficult economic environment.

CHART 8

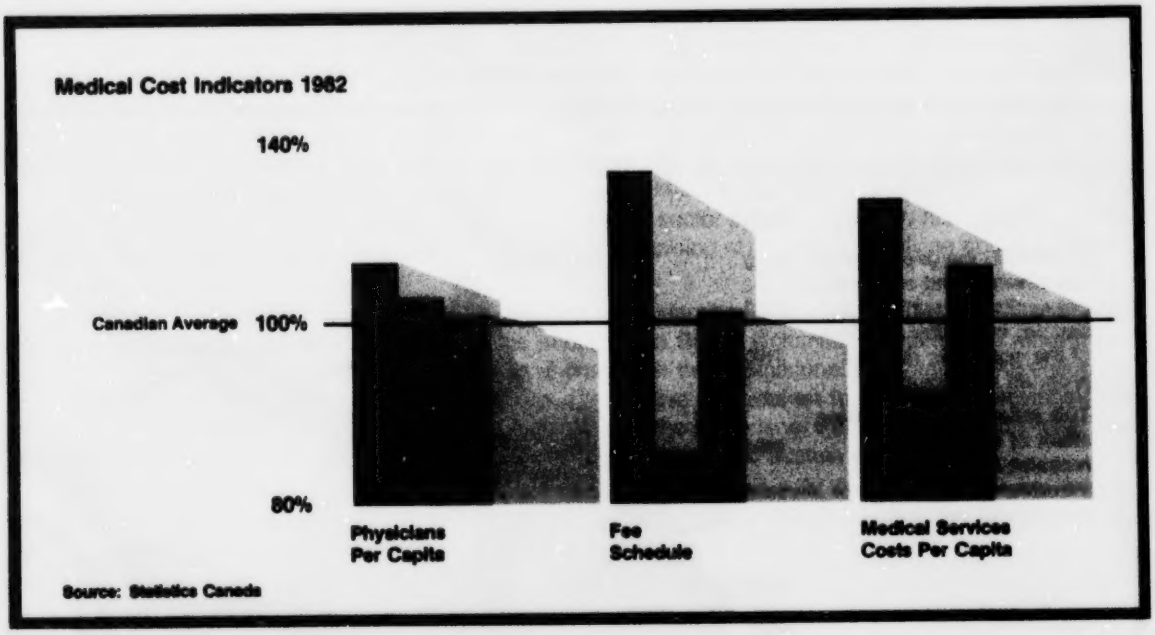


CHART 9

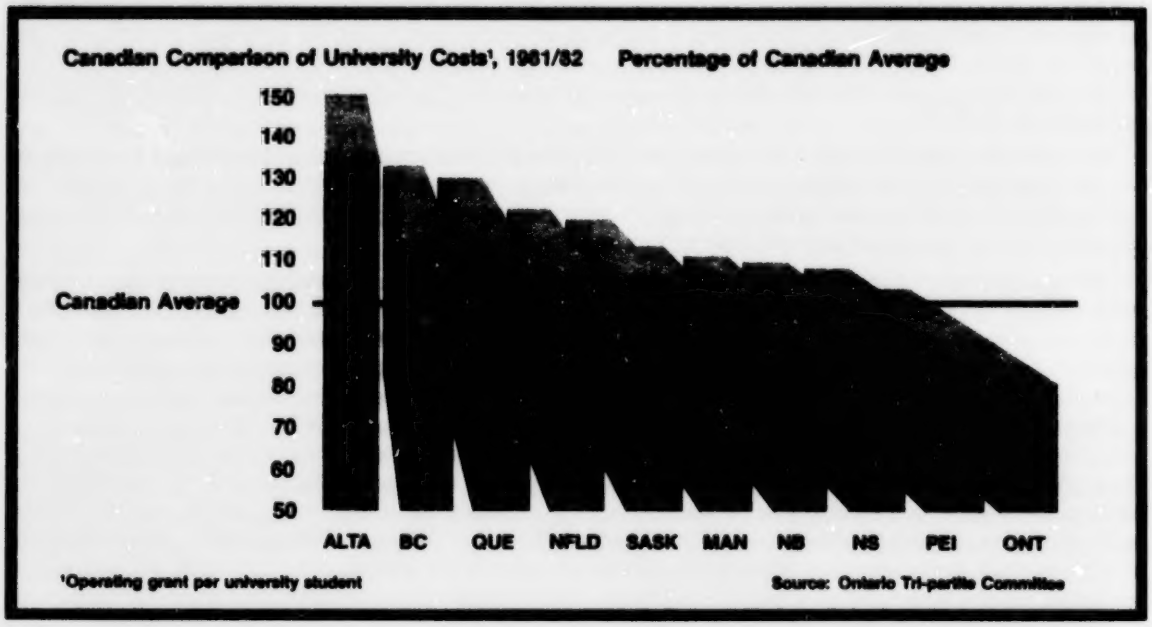
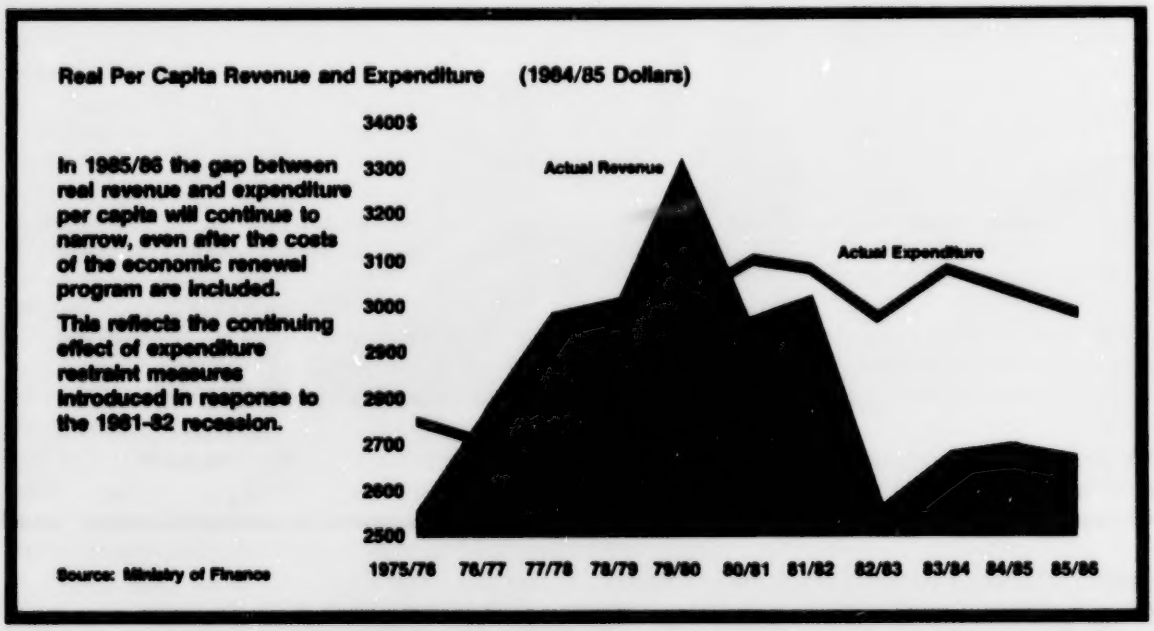


CHART 10


Real Per Capita Revenue and Expenditure (1984/85 Dollars)
In 1985/86 the gap between real revenue and expenditure per capita will continue to narrow, even after the costs of the economic renewal program are included.
This reflects the continuing effect of expenditure restraint measures introduced in response to the 1981-82 recession.
3400$
3300
3200
3100
3000
2900
2800
2700
2600
2500
Actual Revenue
Actual Expenditure
1975/76 76/77 77/78 78/79 79/80 80/81 81/82 82/83 83/84 84/85 85/86
Source: Ministry of Finance

By cutting the cost of government in this manner the provincial government has been able to stabilize and begin reducing the deficit while preserving core social programs and avoiding the build up of pressure to raise taxes in future years.

At the same time the size and scope of government was being reduced, measures were taken to sustain employment and economic activity in the province. Significant government borrowings were undertaken to finance the maintenance of income assistance and other core social programs through the 1981-82 recession. A major program to construct public infrastructure projects such as highways and dykes was also undertaken. In addition, the government sponsored through Crown corporations the construction of major developments including the North East Coal project, the Advanced Light Rapid Transit system, British Columbia Place stadium and Expo 86.

In the past three fiscal years, the government has directly and indirectly provided fiscal stimulus of several billion dollars, which must be repaid through the returns earned on the projects and through higher government revenues generated as the economy recovers and expands. It should be emphasized that the measures chosen were primarily temporary in nature, so as not to add to the permanent expenditure base of the government and undermine the basic fiscal realignment. Construction projects are particularly suitable for this purpose as the expenditures terminate with the completion of the project and the impact on the provincial economy is higher than for most other forms of government spending and much higher than for a government-induced increase in consumer spending.

By avoiding the accumulation of excessive government debt and beginning the process of reducing the deficit, the government's economic program has created the fiscal conditions necessary for resources to be allocated to the next major phase of policy development: policies dedicated to the renewal of British Columbia's economic base.

The 1985/86 provincial budget presents a number of initiatives in a comprehensive program for economic renewal designed to create permanent jobs by strengthening existing industries and encouraging the establishment and expansion of new businesses and industries in the province. The program includes a variety of measures to improve the financial position of British Columbia businesses and to assist them in becoming more competitive in international markets.

Incentives are provided to encourage investment by existing businesses and to promote new business formation in the province. Specific initiatives include major reductions in, and in some cases elimination of, those fixed taxes which represent a cost burden and an impediment to new investment. Industrial development incentives are being introduced to assist in the establishment of new facilities in manufacturing and processing, advanced technology, agricultural products and tourism. Investments are planned to ensure the future well-being of the province's natural resource base, particularly the forests. Major investments are continuing to expand the physical infrastructure for transportation and recreation. Public sector purchasing will be harnessed to provide opportunities for businesses in the province to expand and develop expertise in supplying goods needed to provide public services.

Provincial government economic policy over the past three years has responded positively to the changes in the world economic environment. The conditions under which British Columbia prospered for more than a decade are no longer present and the rapid pace of change in the international economy is presenting new problems and opportunities for British Columbians. Steps have been taken to reduce the province's cost structure and improve the competitiveness of its industries. At the same time, vital social programs have been preserved and projects have been undertaken to build infrastructure and sustain employment.

With the introduction of a new program of partnership for economic renewal, the government is creating the conditions for a new era of economic growth and stability, based on active pursuit of the opportunities presented by the world economy of the future.

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